## APPENDIX A

### Statutes

The allowances for depletion made to Sneed in 1926, were made under the following provisions of the Revenue Act of 1926:

"Deductions allowed Individuals

"Sec. 214(a) In computing net income there shall be allowed as deductions: * * *

"(9) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deduction allowed by this paragraph shall be equitably apportioned between the lessor and lessee; * * *

"Sec. 204(c)(2). In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph."

The Revenue Act of 1936, under which the tax here involved was proposed, levied a tax upon the net income of individuals (section 11) which was determined (see section 21) by deducting from gross income (as

defined in section 22) the deductions allowed by section 23.

Gross income was defined in section 22 to include:

> "* * * gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever."

An allowance for depletion was provided in section 23(m) and section 114(b)(3) in language, insofar as pertinent here, identical with that contained in the Revenue Act of 1926.

In providing for the basis to be used for determining the gain or loss from the sale or other disposition of property, it was provided in section 113 that the unadjusted basis for such property should be adjusted for depletion allowances previously made as follows:

> "Section 113(b)(1) General Rule.—Proper adjustment in respect of the property shall in all cases be made— * * *
>
> (B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this Act or prior income tax laws. Where for any taxable year prior to the taxable year 1932 the depletion allowance was based on discovery value or a percentage of income, then the adjustment for depletion for such year shall be based on

the depletion which would have been allowable for such year if computed without reference to discovery value or a percentage of income; * * *."

The Revenue Act of 1936 contained no provision, other than section 113(b)(1)(B) just above quoted, directing that percentage depletion allowed in a prior year should be taken into consideration to any extent whatsoever in determining taxable income.

## Correlation of Regulations Dealing With Bonus Depletion

### Regulations 45 (1918 Act) Article 215

Depletion—Adjustments of accounts based on bonus or advanced royalty.—(a) Where a lessor receives a bonus or other sum in addition to royalties, such bonus or other sum shall be regarded as a return of capital to the lessor, but only to the extent of the capital remaining to be recovered through depletion by the lessor at the date of lease. If the bonus exceeds the capital remaining to be recovered, the excess and all the royalties thereafter received will be income and not depletable. If the bonus is less than the capital remaining to be recovered by the lessor through depletion, the difference may be recovered through depletion deductions based on the royalties thereafter received. The bonus or other sum paid by the lessee for a lease made on or after March 1, 1913, will be his value for depletion as of date of acquisition.

(b) Where the owner has leased a mineral property for a term of years with a requirement in the lease that the lessee shall extract and pay for, annually, a specified number of tons, or other agreed units of measurement, of such mineral, or shall pay, annually, a specified sum of money which shall be applied in payment of the purchase price or royalty per unit of such mineral whenever the same shall thereafter be extracted and removed from the leased premises, the value in the ground to the lessor, for purposes of depletion, of the number of units so paid for in advance of extraction will constitute an allowable deduction from the gross income of the year in which such payment or payments shall be made; but no deduction for depletion by the lessor shall be claimed or allowed in any subsequent year on account of the extraction or removal in such year of any mineral so paid for in advance and for which deduction has once been made.

### Regulations 69 (1926 Act) Article 216

Depletion—Adjustments of accounts based on bonus or advanced royalty.—(a) Where a lessor receives a bonus in addition to royalties, there shall be allowed as a depletion deduction in respect of the bonus an amount equal to that proportion of the cost or value of the property on the basic date which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the amount remaining to be recovered by the lessor through depletion, and the remainder is recoverable through depletion deductions on the basis of royalties thereafter received.

(b) Where the owner has leased a mineral property for a term of years with a requirement in the lease that the lessee shall extract and pay for, annually, a specified number of tons, or other agreed units of measurement, of such mineral, or shall pay, annually, a specified sum of money which shall be applied in payment of the purchase price or royalty per unit of such mineral whenever the same shall thereafter be extracted and removed from the leased premises, the value in the ground to the lessor, for purposes of depletion, of the number of units so paid for in advance of extraction will constitute an allowable deduction from the gross income of the year in which such payment or payments shall be made; but no deduction for depletion by the lessor shall be claimed or allowed in any subsequent year on account of the extraction or removal in such year of any mineral so paid for in advance and for which deduction has once been made.

(c) If, for any reason, any such mineral lease shall be terminated or abandoned before the mineral which has been paid for in advance has been extracted and removed, and the lessor repossesses the leased property, the lessor shall adjust his capital accounts by restoring to the capital sum of the property the depletion deductions made in prior years on account of royalties on mineral paid for but not removed, and his income account shall be adjusted so as to include the amount so restored to capital sum as income of the year such lease is terminated or the property repossessed, and the tax thereon paid.

(d) Upon the expiration, termination, or abandonment of a lease, without the removal of any or all of the mineral contemplated by the lease, the lessor shall be required to restore to capital account so much of the bonus received and deducted from capital recoverable through depletion as is in excess of the actual depletion or loss in value sustained as a result of the operations under the lease and the corresponding amount will be income for the year in which the lease expires, terminates, or is abandoned.*

*Regulations 62 (1921 Act) Article 215 and regulations 65 (1924 Act) Article 216 followed closely the above quoted article of Regulations 45 (1918 Act). Minor differences in verbiage exist, but these are unimportant, and do not affect the scope or sense of the Article.

(c) If for any reason any such mineral lease shall be terminated or abandoned before the mineral which has been paid for in advance has been extracted and removed, and the lessor repossesses the leased property, the lessor shall adjust his capital accounts by restoring to the capital sum of the property the depletion deductions made in prior years on account of royalties on mineral paid for but not removed, and his income account shall be adjusted so as to include the amount so restored to capital sum as income of the year such lease is terminated or the property repossessed, and the tax thereon paid.

(d) Upon the expiration, termination, or abandonment of the lease, without the removal of any or all of the mineral contemplated by the lease, the lessor shall be required to restore to capital account the excess of the depletion theretofore allowable in respect of the bonus and royalty payments over the actual depletion or loss in value sustained as a result of the operations under the lease, and a corresponding amount must be returned as income for the year in which the lease expires, terminates, or is abandoned.

(e) In lieu of the treatment provided for in the above paragraphs the lessor of oil and gas wells may take as a depletion deduction in respect of any bonus, royalties, and other income from the property for the taxable year 27½ per cent of the amount thereof, but the deduction shall not exceed 50 per cent of the net income (computed without allowance for depletion) from the property.*

*Article 236 Regulations 74 (1928 Act); Article 230 Regulations 77 (1932 Act); Article 23(m)-20 of Regulations 86 and 94 (1934 and 1936 Acts) follow closely the above quoted Article 216 of Regulations 69 (1926 Act). There are minor differences in verbiage, but these are unimportant and do not affect the scope or sense of the later regulations.

## APPENDIX C

*Crabb v. Commissioner*, 119 Fed. (2d) 772 (C. C. A. 5th) — dissenting opinion of Circuit Judge Hutcheson:

"I think it plain that the opinion in the *Sneed* case which the majority opinion adopts here, erroneously held applicable to the statutory 27½% depletion, or if applicable, erroneously held valid, the regulation of the Commissioner for restoring depletion taken on the cost basis, because as so applied, it is both invalid and unjust. I therefore dissent from the holding that the statutory 27½% depletion taken in 1934 on an oil lease cash bonus, received in that year, must be returned as income in 1936, when the lease lapsed without any oil or gas having been produced therefrom.

"The statute in making its provision for an arbitrary depletion allowance of 27½% makes no provision for restoring any part of it. The provision in 23 M,[1] on which the majority relies, that the reasonable allowance there provided, shall be made under rules and regulations to be prescribed by the Commissioner, does not support, it defeats the majority view. For, by its clear and definite provisions for a reasonable allowance as contrasted with the fixed arbitrary of 27½% allowed under Section 114-(3), the statute shows beyond question that while the depletion on cost basis, was

[1]Sec. 23(m) Depletion.—"In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * *."

to be a reasonable sum to be allowed under Commissioner's rules, the Statutory 27½% depletion was to be allowed whether reasonable or not, and was fixed not under rules to be established by the Commissioner, but at the arbitrary figure of 27½%.

"I think it clear therefore, that when the taxpayers in the exercise of their option, elected to take their depletion on their cash bonus, on the arbitrary, rather than the cost basis, they did so, with the knowledge that they might never get their cost back and might therefore, be paying taxes not on gains but on capital. Having elected that course with its chances of gain, if their capital cost was low, and of loss if their capital cost was high, they may not be interrupted in midflight, and dashed to the ground by the application to them of a regulation designed for and applicable only to cost basis depletion.

"The opinion in the *Sneed* case, with I think, total irrelevance, and with deference, without a full consideration of the fact, that the law and regulations apply as well to taxpayers whose costs in the acquisition of oil lands and leases are high, as to those whose costs are low, states; 'the percentage depletion allowance is more favorable to the taxpayer as its choice in this and other cases, shows. It should not be made still more favorable by making it final in the case of a bonus deduction.' This consideration, whether the law is more or less favorable to the taxpayer than it ought to be, is of course, under our constitutional system, matter for Congress, and not for the courts, and cannot of itself, add words to or take them from a statute or permit the Commissioner or the courts to do so. Without doubt, Congress took into con-

sideration, the oil business as a whole and determined that the law as enacted, would in the long run, while furnishing a simple and workable system, apply justly to both taxpayer and government. Being a general law and not one for an individual case, it applies as well to those who own their oil rights at small cost and to those who have paid large sums for them. It was designed to furnish to those who preferred to take the long run chance that they would get their capital investment back that way, a simple and easy method of doing so, in lieu of the more complicated but more certain method of getting it back, provided under the Commissioner's rules for taking it on the cost basis.

"To apply the cost basis rules, promulgated by the Commissioner, to the taxpayers here who have elected not the cost, but the arbitrary basis, is for the government to keep the promise to the ear while it breaks it to the hope. It is to nullify the statutory grant of an arbitrary depletion, by the application to it of a regulation, not promulgated or intended to apply to such cases, and if intended, without effect as to them, because not authorized by the statute.

"It is true enough that by a rough and ready measurement the arbitrary allowance is supposed to produce and perhaps speaking roughly, does produce, as to taxpayers as a whole, substantially the same result as the cost basis. But it is equally true as said by the board in this case, in holding that because there was some, though very small production from one tract, there could be no restoration of the depletion allowance, 'Percentage depletion is not based on cost and has no relationship to cost. Under the respondent's own ruling,

(the 1935 G. C. M., 14,448, C. B. XIV-1, Page 98), the depletion allowed in 1934 should not be restored to income because there has been actual production.' (41 B. T. A. 686-700.)

"It will be here noted that the ruling referred to and on which the board and the court rely, was made in 1935, after the depletion in this case had been taken and it is made *ex post facto* in an effort to conform the regulation to a situation it had not been written to apply to, the holding in *Herring v. Commissioner*, 293 U. S. 322, that a cash bonus was depletable. The ruling of the Commissioner had theretofore been uniform that these regulations did not apply to cash bonuses, that these were not depletable income but were capital gains. When we turn to Treasury Regulation No. 69,[2] promulgated under the Revenue Act of 1926 and in force when the depletion was taken, we find its language and effect wholly inconsistent with the construction now contended for it, that it relates to or deals with the arbitrary 27½% depletion.

"Nowhere in it is the arbitrary depletion referred to. That is dealt with in Article 221, and no provision is made there for its return. Article 216 in every line of it shows that it is dealing with a situation under which the taxpayer is working on the

[2]Art. 216. Depletion.—Adjustments of accounts based on bonus or advanced royalty. * * *.

(d) "Upon the expiration, termination, or abandonment of the lease, without the removal of any or all of the mineral contemplated by the lease, the lessor shall be required to restore to capital account the excess of the depletion theretofore allowable in respect of the bonus, and royalty payments over the actual depletion or loss in value sustained as a result of the operations under the lease, and a corresponding amount must be returned as income for the year in which the lease expires, terminates, or is abandoned."

cost basis. When such a regulation is sought to be applied to an arbitrary depletion, especially when that has been taken as to a cash bonus, which the Commissioner has all along ruled was not covered by this regulation, the taxpayer finds himself in the position of having paid taxes as on income, on money which was really a return of capital. No matter that the courts have called it a bonus,[3] and having then taken away from him even the small alleviation furnished by the 27½% reduction which under the statute, as construed in the *Herring* case, had been allowed him. I therefore think it plain that the majority opinion has applied Article 216 to this case, when it was not intended to be so applied.

"If, however, I am mistaken in this and it must be considered that the 1926 regulation as interpreted in the 1935 bulletin and the Treasury Regulation 94, promulgated under the 1936 Act,[4] were intended to have application in an arbitrary depletion case, I think it perfectly clear that it is invalid as an attempt to amend or rewrite the Statute to meet the Helvering decision, holding a cash bonus not a return of capital but advance royalty and depletable as such. Since the majority has advanced, as a reason for ruling against the taxpayer, the advantages to the particular taxpayer, of the ruling he contends for, I think I may be par-

[3]Charles Pettit v. Comm., 118 Fed. (2d) 816.

[4]"If for any reason any such mineral lease expires or terminates or is abandoned before the mineral which has been paid for in advance has been extracted and removed, the lessor shall adjust his capital account by restoring thereto the depletion deductions made in prior years on account of royalties on mineral paid for but not removed, and a corresponding amount must be returned as income for the year, in which the lease expires, terminates, or is abandoned."

doned by advancing the unrealities, the unreasonablenesses, the injustices which flow from such an attempt, as stronger arguments against the ruling.

"Under the application of this regulation, as contended for by the majority, these unreasonable results not only may occur, they are certain to. A and B own two adjoining tracts of land. A bought his as agricultural land and for a small price. B bought his as oil land and for a large price. A and B lease their land in the same year. Each received a large cash bonus and a royalty; a great deal more than A's cost, a great deal less than B's, each thinking they had an oil field and that it was to his advantage to do so, take the percentage depletion. A, who has a small cost, is lucky again and has a few dollars of production on his land. B, with his heavy cost, is still out of luck, and has none. Both leases are abandoned in the same year. B, who has a heavy capital investment and has already paid income on cash received which was far less than his investment, is required because he had no production, to pay income on his depletion. A, who has a small capital investment, because he had a small production, is allowed to keep his full depletion. The statute allowing not a cost but an arbitrary depletion was not intended to operate in that way, and the Commissioner cannot, by regulation, make it so operate. It was intended to operate alike by giving all persons who took that method of depletion, the benefit of it without regard to wether they had no, little, or large production. To use the regulation to make it operate differently as between taxpayers, is not to carry out the purpose of the statute, it is by rewriting it, to defeat that purpose.

"I respectfully dissent."